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FISCAL IMPACT STATEMENT

LS 6401
BILL NUMBER: HB 1075

NOTE PREPARED: Jan 27, 2014
BILL AMENDED: Jan 27, 2014

SUBJECT: PERF and TRF Annuities.

FIRST AUTHOR: Rep. Burton
FIRST SPONSOR:

BILL STATUS: CR Adopted - 1st House

FUNDS AFFECTED: X **GENERAL**
X **DEDICATED**
FEDERAL

IMPACT: State & Local

Summary of Legislation: (Amended) The bill provides that the board of trustees of the Indiana Public Retirement System (INPRS) may not, before October 1, 2019, enter into an agreement with a third-party provider to provide annuities for retiring members of the Public Employees' Retirement Fund (PERF) or the Indiana State Teachers' Retirement Fund (TRF).

The bill also requires INPRS to establish not later than July 1 of each year (beginning July 1, 2014) the interest rate used to determine the annuity amount purchasable by a member of PERF or TRF who elects to receive an annuity in the member's Annuity Savings Account. It specifies the method for establishing the interest rate.

Effective Date: Upon passage.

Explanation of State Expenditures: (Revised) In order to address the problem of realized losses in the practice of providing annuities to retirees (see *Additional Information* below), the INPRS board of trustees plans to utilize a third-party provider to provide annuities (at a market interest rate with adjusted mortality tables) to retirees beginning October 1, 2014.

The bill prevents contracting with a third-party provider to provide annuities. The impact of this specific provision is: (a) the potential cost of the contract; and (b) the potential savings in INPRS personnel from not conducting annuities in-house. The bill does not preclude INPRS from changing their interest and mortality assumptions in order to stem the losses associated with ASA annuities, so long as the annuitization remains in-house at INPRS.

Contracting with a third-party provider may result in significant administrative savings to INPRS over time. However, any annuity savings accounts (ASAs) that are annuitized through INPRS prior to the October 1, 2014, date will still continue to be administered by INPRS for the remainder of the life of the member - this dual administration will result in a delay in many administrative savings until such time as the current annuity beneficiaries are deceased.

The costs associated with the contract are unknown, as a third-party provider has not yet been chosen. However, it is reasonable to assume that costs associated with the utilization of a third-party provider will be passed on to members who opt to annuitize their ASAs, primarily in the form of account fees.

The bill's requirement that INPRS set annuity rates is based on two factors: (1) the rate of return earned by the retirement allowance accounts of PERF and TRF for the 3 months preceding July 1; plus (2) the average daily interest rate on 10-year United States Treasury bills for the 3 months preceding July 1. If the INPRS rate of return is a negative number for that particular quarter, the rate of return is presumed to be 0%. These two separate interest rates are summed and multiplied by a factor of 0.66.

For this estimate, LSA utilized daily ten-year treasury bill rates (nominal and not inflation-indexed, although the bill does not specify) from October through December 2013. As well, LSA utilized annual INPRS rates of return from 2004 through 2013. Using available data, the bill would most likely result in annuity rates of roughly 4.5 - 6% in a stable economy, but may be as high as 15% and as low as 2%, depending upon market conditions. This estimate is based on the INPRS five- and ten-year return averages as well as upper and lower bound rates of return. It is reasonable to assume that, as the bill requires recalculation of the annuity rate each quarter, that the actual three-month rates of return may fluctuate even more than the yearly or multiple-year rates of return, as used here.

The annuity rates that are ultimately used for ASA annuities will have a direct impact on whether INPRS continues to realize losses with annuitization of ASAs. Generally speaking, INPRS will continue to realize losses if annuities are paid out at a rate that is greater than the actual investment rate of return and will realize a savings if annuities are paid out at a rate that is less than the actual investment rate of return. The "baseline" or target long-term rate of return for the retirement allowance accounts of PERF and TRF are 6.75%. It is reasonable to assume that any deviation from the expected return of 6.75% will affect the unfunded liability of both PERF and TRF.

(Revised) *Additional Information*: PERF and TRF members participate in a hybrid pension system, consisting of both a typical pension benefit and an annuity savings account, which is funded by member contributions. Members may annuitize the ASA at retirement by taking the ASA amount in combination with the pension as a lifetime monthly payment. Or, members may choose to receive a distribution of the ASA funds, either at retirement or at a later date. Approximately 50% of PERF and TRF retirees opt to have INPRS annuitize their ASAs.

Due to the use of out-of-date interest and mortality assumptions, INPRS has been annuitizing ASAs for members at a loss to PERF and TRF. Currently, INPRS is paying a rate for annuities to retirees (7.5%) that is higher than INPRS expects to earn through investments (6.75%) on both the PERF and TRF plans. Once a member has their ASA annuitized through INPRS, the amount in the individual's ASA becomes part of the larger pension/defined benefit pool, both from an investment and accounting perspective. The ASA funds are invested with the target of earning 6.75%, which is the same as the larger pension/defined benefit plan.

Additionally, INPRS has been using outdated mortality assumptions for PERF annuities, which does not account for the longer lifespan of current and future retirees. The mortality tables for TRF are not outdated and therefore are not contributing to losses with the ASA annuitization.

By continuing to use the current interest and mortality assumptions, INPRS will have accrued realized losses from annuitization to PERF and TRF of approximately $235 M by October 1, 2014. By continuing with current practice and not adjusting either the interest rate or the mortality assumptions (either by making an in-house administrative change or by utilizing a third-party provider), PERF and TRF will continue to realize losses of roughly $2 M per month until such time as these status quo assumptions are changed. The bill does not affect the mortality assumptions that are currently being used. Out of the $2 M per month losses, mortality accounts for $0.92 M. Consequently, if the bill's methodology results in an interest rate of about 6.75%, losses are estimated to decrease by roughly $1.08 M per month.

The board opted for the third-party solution as opposed to making internal administrative changes that would have also resulted in the correction of the problem, as the use of a third-party provider shifts the risk associated with the annuitization to the third-party provider and away from the pension funds themselves.

Changes to the interest and mortality assumptions will affect the level of benefits that will be received by members who choose to annuitize their ASAs.

The state will bear the costs associated with the state-funded portion of PERF and the TRF Pre-1996 Fund. The cost to the local PERF portion and the TRF 1996 Fund will impact local units.

PERF is prefunded wholly through employer contributions, which were 11.2% of payroll as of July 1, 2013, for state PERF and will be 11.0% of payroll beginning on January 1, 2014, for most local political subdivisions that participate in PERF.

The TRF 1996 Fund is prefunded through employer contributions, which are currently 7.5% of payroll. The TRF Pre-1996 Fund is paid for via the state General Fund and the Pension Stabilization Fund.

Explanation of State Revenues:

Explanation of Local Expenditures: See *Explanation of State Expenditures*.

Explanation of Local Revenues:

State Agencies Affected: INPRS, All.

Local Agencies Affected: Local units with members in PERF and local school corporations with members in TRF.

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